

**Preparations Were Successful for
Implementation of Two New Business Tax
Credits**

September 2003

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 16, 2003

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Assistant Inspector General for Audit (Small Business and
Corporate Programs)

SUBJECT: Final Audit Report – Preparations Were Successful for
Implementation of Two New Business Tax Credits
(Audit # 200330003)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) identified the new tax law provisions that had a significant impact on Small Business/Self-Employed (SB/SE) taxpayers and ensured that tax forms, instructions, and publications related to these new provisions were either created or clearly and accurately updated for the processing of Tax Year 2002 tax returns.

The audit focused on two new provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA):¹ the credits for employer-provided child care facilities and services, and small employer pension plan startup costs. The Joint Committee on Taxation estimated that these new provisions could provide tax benefits of up to \$120 million for Fiscal Year 2003.

In summary, the IRS successfully ensured that tax products were revised or created to implement the two new tax credits affecting small business taxpayers. Also, the IRS effectively informed taxpayers and practitioners of the law changes and their impact through announcements and news articles, and effectively updated processing instructions to ensure that returns claiming the new credits would be accurately processed.

¹ Pub. L. No. 107-16, 115 Stat. 38 (2001).

We made no recommendations in this report and no response is required by IRS management. However, key IRS management officials reviewed it prior to issuance.

Copies of this report are also being sent to the IRS managers affected by it. Please contact me at (202) 622-6510 if you have questions, or Parker F. Pearson, Director (Small Business Compliance), at (410) 962-9637.

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Preparations Were Successful for Implementation of Two New Business Tax Credits

Background

President George W. Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)¹ on June 7, 2001, to provide economic stimulus and assistance to small business and individual taxpayers. In this Act, there are 13 major provisions relating to taxpayers who are serviced by the Small Business/Self-Employed (SB/SE) Division of the Internal Revenue Service (IRS). Seven of these provisions became effective January 1, 2002. Two of the provisions that became effective on January 1, 2002, are new while the others are either modifications to or extensions of tax laws already being administered by the IRS. The two new provisions effective for Tax Year (TY) 2002 were a credit for employer-provided child care facilities, and a credit for small employer pension plan startup costs. These two new provisions were considered significant because the Joint Committee on Taxation estimated that they could provide tax benefits of up to \$120 million in Fiscal Year 2003.

Annually, the IRS must revise or create new tax products to implement new legislation. The IRS function responsible for tax products is the Tax Forms and Publications Division. Tax law specialists in this function are assigned specific tax products and are responsible for interpreting the tax law, determining the changes needed, and making the changes that the Congress intended in the legislation.

Our audit work was conducted at the Brookhaven IRS Campus² from February through May 2003. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on the audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

¹ Pub. L. No. 107-16, 115 Stat. 38 (2001).

² The campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

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Tax Products Were Revised or Created to Implement New Sections of the Tax Law Affecting Small Business Taxpayers

The IRS successfully identified the tax products affected by the two new tax credits created by the EGTRRA. The IRS also took the necessary actions to ensure that tax forms and publications and IRS processing instructions were effectively changed.

New tax forms were effectively developed

The Tax Forms Development Branch successfully created two original tax forms to implement the new sections of the Internal Revenue Code (I.R.C.) that became effective for TY 2002.³

I.R.C. Section (§) 45(E)⁴ provides a credit based on costs incurred by an employer in establishing or administering an eligible employer plan or for the retirement-related education of employees with respect to the plan. The credit is computed based on 50 percent of the qualified startup costs for the tax year, up to a maximum credit of \$500 for the first tax year and each of the 2 subsequent tax years. Credit for Small Employer Pension Plan Startup Costs (Form 8881) has been specifically developed for the reporting of this credit.

I.R.C. § 45(F)⁵ also provides a credit based on costs incurred by an employer in providing child care facilities and resource and referral services. Credit for Employer-Provided Child Care Facilities and Services (Form 8882) has been developed for the reporting of this credit.

For the taxable year, the credit is computed based on:

- Twenty-five percent of any qualified child care facility expenditures; plus
- Ten percent of any qualified child care resource and referral expenditures.

The maximum credit amount for the tax year is \$150,000.

³ Section 619 of the EGTRRA amended the I.R.C. by adding Section 45(E). Section 205 of the EGTRRA amended the I.R.C. by adding Section 45(F).

⁴ 26 U.S.C. § 45(E) (2001).

⁵ 26 U.S.C. § 45(F) (2001)

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Availability of credits was effectively communicated to small businesses

The IRS adequately informed taxpayers of the law changes through various publications. In addition, the IRS effectively informed taxpayers and practitioners of the law changes and their impact through media announcements and news articles.

The Office of Tax Administration Coordination (OTAC) has developed the Legislative Implementation Tracking System (LITS) as the primary control to monitor new tax laws. The LITS was designed to help ensure that new tax laws are successfully implemented on a timely basis.

Our review of the LITS identified specific actions that were required to revise and/or update tax products (forms, instructions, and publications) to assist small business/self-employed taxpayers in claiming credits for child care facilities and pension plan startup costs.

Some of the specific tax publications that were updated because of the new provisions include:

- Publication 225, *Farmer's Tax Guide*.
- Publication 334, *Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)*.
- Publication 542, *Corporations*.
- Publication 553, *Highlights of 2002 Tax Changes*.

In addition to the changes to the publications, we identified one existing tax form – General Business Credit (Form 3800) – that was effectively changed, as well as the instructions for completing the form.

All necessary tax form instructions were revised, including:

- U.S. Income Tax Return for Estates and Trusts (Form 1041).
- U.S. Corporation Income Tax Return (Form 1120).
- U.S. Corporation Short-Form Income Tax Return (Form 1120-A).

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- U.S. Income Tax Return for an S Corporation (Form 1120-S).
- U.S. Income Tax Return of a Foreign Corporation (Form 1120-F).

IRS processing instructions were updated effectively

The LITS also identified the changes to IRS processing instructions needed to ensure that tax returns claiming these new credits could be processed effectively. Internal Revenue Manual (IRM) instructions were updated for processing various related tax forms. We determined that the instructions were effectively revised to incorporate the two new credits.

For example, the IRM was updated to:

- Provide explanations to IRS employees who prepare returns for data entry, regarding the appropriate coding and editing procedures for the two new credits.
- Add the new credits to the IRS' error correction system and provide instructions for disallowing the credits claimed erroneously for prior years.
- Provide new prompts and instructions for IRS employees who enter data from tax returns into the IRS' computer system.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) identified the new tax law provisions that had a significant impact on Small Business/Self-Employed (SB/SE) taxpayers and ensured that tax forms, instructions, and publications related to these new provisions were either created or clearly and accurately updated for the processing of Tax Year (TY) 2002 tax returns. To accomplish the objective, we conducted the following steps:

1. Reviewed the tax law Economic Growth and Tax Relief Reconciliation Act of 2001¹ and identified significant tax law changes that would impact TY 2002 returns and determined what steps were taken to effectively implement them. Specifically, we concentrated on two new provisions dealing with credits for employer-provided child care facilities, and small employer pension plan startup costs.
2. Evaluated the Legislative Affairs Early Action Plans to determine if the plans identified changes needed for computer programs, tax forms and instructions, publications, and processing procedures.
3. Determined whether necessary actions were taken to update computer programs and processing procedures and adequately inform taxpayers and tax practitioners of the new laws.
 - A. Reviewed the adequacy and completeness of computer instructions related to the two new tax law provisions.
 - B. Determined whether tax forms, instructions, and publications were timely and accurately prepared, and used plain, clear, and courteous language that would help facilitate taxpayer compliance with the two new tax law provisions.
 - C. Reviewed tax forms and relevant schedules to ensure that they complied with the tax law provisions and were clear and easily understood.

¹ Pub. L. No. 107-16, 115 Stat. 38 (2001).

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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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Director, Tax Forms and Publications, Wage and Investment Division W: CAR: MP: T
Director, Communications and Liaison, Small Business/Self-Employed Division S
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